DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

OFFICE OF
CHIEF COUNSEL

JUN - 4 2001

MEMORANDUM FOR DIRECTOR, SUBMISSION PROCESSING W:CAS:SP
Attention: Doris Sheridan

FROM: Associate Chief Counsel
(Income Tax and Accounting) CC:IT&A

SUBJECT: Review of IRM 3.17.79.16.19
PUB-112512-01

This memorandum responds to your request for assistance dated February 26, 2001. You requested that Counsel review certain IRM procedures concerning the issuance of Forms 1099-C, Cancellation of Debt, for unrecoverable nonrebate erroneous refunds. Because these IRM procedures involve information reporting matters, we have coordinated this response with the Administrative Provisions and Judicial Practice Division (CC:PA:APJP).

Currently, IRM 3.17.79.16.19(1) provides that "[u]nrecoverable erroneously paid refunds are considered income to the recipient." That section further provides that Forms 1099-C are issued to taxpayers receiving such refunds. However, in most situations it would not be appropriate to issue a Form 1099-C. In situations where the nonrebate erroneous refund is income in the year it is received, a Form 1099-C should not be issued for any year. Instead, the Service should issue a Form 1099-MISC, Miscellaneous Income, with respect to the year the nonrebate erroneous refund is received and include the amount of the refund under line item entry number 3, "Other income." We are providing the following analysis of when a nonrebate erroneous refund is considered income for a cash basis taxpayer.

Initially, it is important to note the situations where a nonrebate erroneous refund is not considered income. A taxpayer does not have income if the taxpayer returns the check to the government within the same tax year. Also, if a taxpayer cashes the nonrebate erroneous refund check, but such amount is repaid within the same tax year it was received, it is not income. See Bishop v. Commissioner, 25 T.C. 969 (1956), acq., 1956-2 C.B. 5.

If a nonrebate erroneous refund is not repaid within the same tax year, we must determine whether there was an affirmative act constituting a bona fide mutual recognition of a fixed obligation to repay and whether such act occurred within the same tax year as the nonrebate erroneous refund was received. If there was no

such mutual recognition or it occurred in a later tax year, then the nonrebate erroneous refund is income under "claim of right" in the year it is received. See, e.g., United States v. Merrill, 211 F.2d 297 (9th Cir. 1954). If there was a bona fide mutual recognition of a fixed obligation to repay that occurred within the same tax year, then generally the nonrebate erroneous refund would not be income in the year received. See Merrill, 211 F.2d at 303-304; see also Commissioner v. Gaddy, 344 F.2d 460 (5th Cir. 1965); Nordberg v. Commissioner, 79 T.C. 655, 665 (1982), aff'd without published opinion, 720 F.2d 658 (1st Cir. 1983); Hope v. Commissioner, 471 F.2d 738 (3d Cir. 1973), cert. denied, 414 U.S. 824 (1973); but see Quinn v. Commissioner, 524 F.2d 617, 624 (7th Cir. 1975) (held that Merrill exception to "claim of right" doctrine not applied in that circuit); Buff v. Commissioner, 496 F.2d 847, 849 (2d Cir. 1974) (concurring opinion states that Merrill was erroneously decided). As noted in the preceding citations, the Court of Appeals for the Seventh Circuit has rejected the Merrill exception. Consequently, in that circuit a nonrebate erroneous refund is income under "claim of right" in the year it is received regardless of whether there was a bona fide mutual recognition of a fixed obligation to repay that occurred within the same tax year. Of course, in those circuits that have not specifically addressed this issue, it is not clear whether the Merrill exception would be accepted or rejected.

Assuming that a nonrebate erroneous refund would not be income in the year received because of the Merrill exception, we must then determine the applicable period of limitations under § 6532(b) of the Code to determine when there might be income in a subsequent year. For cases subject to the 2-year period of limitations under § 6532(b), there could be discharge of indebtedness income two years after the nonrebate erroneous refund (recognized as an obligation to repay) was received if it is not repaid prior to that time. For cases subject to the 5-year period of limitations, there could be discharge of indebtedness income five years after the nonrebate erroneous refund (recognized as an obligation to repay) was received if it is not repaid prior to that time. However, because such a nonrebate erroneous refund was induced by fraud or misrepresentation of a material fact, it will be doubtful whether any mutual recognition of an obligation to repay was actually bona fide, thereby leading back to income under "claim of right" in the year received. Cf. Buff, 496 F.2d 847.

In those few situations where the nonrebate erroneous refund is not income in the year it is received, it may be appropriate to issue a Form 1099-C if and when an identifiable event occurs under § 1.6050P-1(b)(2) of the Income Tax Regulations. Please see the attached memorandum from Branch 1 of the Administrative

Provisions and Judicial Practice Division for an analysis of this issue.

If a member of your staff has any questions about this memorandum, please call Robert Basso at 622-8248.

Associate Chief Counsel
(Income Tax and Accounting)

By _____
Christopher F. Kane
Assistant to Branch Chief,
Branch 2

Attachment

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CC:PA:APJP:1:RADesilets
PUB-112512-01

MEMORANDUM FOR MICHAEL D. FINLEY
CC:IT&A:3 BRANCH CHIEF
Attn: Robert Basso

FROM: James C. Gibbons
Branch Chief
CC:PA:APJP:1

SUBJECT: Review of IRM 3.17.79.16.19

In those situations in which there is an acknowledgment by the taxpayer of the existence of a non-rebate erroneous refund and his or her need to repay, such amount is properly characterized as debt in the year in which the refund is received. In order for a 1099-C to issue, a discharge of indebtedness must be made in connection with an established business plan, or as a result of the expiration of the statute of limitations for collection of such indebtedness. See, §§ 1.6050P(b)(2)(i)(C) & (G). The propriety of the issuance of a 1099-C by the Service under either of these circumstances is suspect, however, in situations where the Service does not pursue a non-rebate erroneous refund within the applicable period of limitations. The Service is seemingly prohibited from issuing a 1099-C under a debt write-off plan because it does not have one in place. Similarly, the regulations governing the issuance of Form 1099-C preclude issuance in the event that the Service has failed to pursue its required judicial remedy.

If you have any questions, please contact Rob Desilets, Jr. at 622-7179.